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SUBJECT: INDONESIA TARGETS COST RECOVERY IN OIL AND GAS PRODUCTION CONTRACTS

¶1. (SBU) Summary. The Indonesian government instituted a negative list for cost recovery items under oil and gas production sharing contracts, in a decree signed June 30 and released publicly in early August. Oil and gas companies noted that the regulations disallowed expenses that had been allowed for decades, although they acknowledge the political pressures surrounding oil and gas production costs. There are different signals within the Ministry of Energy and Mineral Resources on the next steps for cost recovery - the MIGAS Director General declared that future oil and gas production contracts may not include cost recovery provisions, while the Chairman of BP Migas stated that cost recovery would have to remain in the contracts. End Summary.

The Cost Recovery Negative List

¶2. (U) In early August the Minister of Energy and Mineral Resources (MEMR) notified companies of Decree Number 22, a negative list of cost recovery categories signed by Minister Purnomo Yusgiantoro on June 30. The new regulations disallow cost recovery for seventeen expense categories, including foreign worker costs, tax and legal consultants, certain kinds of public relations, environmental and community development, fees for site abandonment and restoration, cost overruns, and costs due to operating errors.

¶3. (U) The decree follows a period in which BP Migas has become more stringent on the types of costs that it would allow for cost recovery. Many foreign companies have complained that expenses that have been transparently declared and allowed for decades, and on which they based their cost estimates, are being denied.

¶4. (SBU) The Indonesian Petroleum Association, representing foreign and domestic oil and gas producers, has been engaging the Indonesian government on the cost recovery issue. Because of the political sensitivities surrounding cost recovery, changes to the regulations have been rumored for some time. However, IPA President Roberto Lorado expressed surprise that the regulations were finalized before the government completed consultations with the industry.

Calls for Cost Containment

¶5. (U) Cost recovery has become a hot political issue in Indonesia, spurred by the rising cost of fuel subsidies and declining domestic production of oil and gas. Adding to the concern is the fact that production costs are rising as producers use new equipment and procedures to maximize output at aging fields. The press has run stories on alleged improper cost recovery charges for several years, citing items such as DVDs, parties, dance lesson, and charities, indicating that bill-padding is a major problem in production

sharing contracts (PSC).

¶6. (U) With the public perception that rising costs are due to inefficiency and corruption, demands to reduce cost recovery charges have become more heated. Several members of the legislature recently called for cost recovery payments to be reduced to a 15% average of oil and gas revenues, down from the current 23% average. BP Migas, the oil and gas upstream regulator, has pointed out that the 15% goal is unrealistic, noting that cost recovery constitutes 40% to 60% of gross revenues in some oil and gas producing countries. As production moves further offshore and into deeper waters in Indonesia, BP Migas sees costs rising, not falling.

Will Cost Recovery Disappear?

¶7. (SBU) Amid the debate on cost recovery, the Director General for Oil and Gas (Dirjen MIGAS) Evita Legowo stated at a press conference on July 28 that the Indonesian government may do away with cost recovery entirely in future contracts for oil and gas development. Although this statement was made prior to the announcement of the cost recovery negative list, MIGAS officials, who are responsible for overall policy for oil and gas exploration and production, indicated that eliminating cost recovery remains an option.

¶8. (SBU) The Chairman of BP Migas, R Priyono, stated his opposition to eliminating cost recovery in a conversation with Econoff. While stressing that the Indonesian government will only enter into contracts that maximize the benefits to the country, he acknowledged that PSCs are the best option, and cost recovery is a necessary component of a PSC. Of the two primary types of contracts that do

not require cost recovery - technical services contracts (TSC) or royalty/tax systems - Priyono sees neither as appropriate for Indonesia. In a TSC, Pertamina would manage all production and hire companies to do drilling and production services only, and Priyono does not believe that Pertamina has the capacity or capital to manage these contracts nationwide. He is also not in favor of tax and royalty systems, despite their popularity with production companies, because he does not believe they provide the government with enough control over these necessary commodities.

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